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Comment: Detecting fraud in China

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Investing in China requires a thorough understanding of the country's intertwined politics and economics.

Conducting company due diligence in China can be a risky undertaking. Company filings are inadequate, financial statements often cloak the truth, and executives are prone to mislead investors.

There are two metrics often overlooked by Western investors that are helpful in judging whether a company is shaky or an outright fraud: Related Party Transactions (RPT) and what I call “State Connections.” The degree of RPTs to assets is a good indicator of potential fraud. The academic literature (and there are a number of studies on corporate behavior in China) suggests that a high level of RPTs is an indication of a firm that may be allocating profits internally in ways that may not benefit other holders. Often these tricks stem from a requirement to please or even pay off government officials.

For listed companies, RPTs can be pulled from the financial statements. For private firms, it’s often harder, but company officials often will state in interviews (or sometimes on the company website) which firms they do business with that are directly or indirectly related. Among the tricks companies use are:

Prelisting Games. Manipulation of earnings among internal units in order to meet government requirements for new equity offerings.

Avoiding Delisting. Publicly traded firms often will manipulate internal profits to avoid flouting listing rules. China has specific criteria for a company’s capital and other measures that if contravened, will get their shares pulled from the market. A delisting often spells the death knell for a career bureaucrat’s career, all the way up to chairman, often who may double as a government official. That’s why they will go to extraordinary lengths to adapt the financials to fit the listing criteria.

High Accounts Receivables. This goes to the heart of corporate governance in China. Companies with substantial free cash flows often will divert them to other group members by offering generous trade credits. They may do this as a face-saving gesture for an ailing subsidiary, or in some cases, as a cover-up for passing profits to a unit indirectly owned by a company official or his family. Chinese securities law is very weak here.

The area of most confusion for westerners investing in the Chinese market is the relationship between a company and the State. I use the term “State” instead of government because there are many different levels of government – Beijing, Province, Local Township, and regulators. State participation is a double-edged sword; at times, the relationship can be beneficial. One example is local subsidies. There is a great deal of inter-Provincial competition that forces competition for new projects. We visited an auto company that was being showered with subsidies and tax cuts in exchange for construction of a new plant.

However, state involvement can be highly negative. This can include excessive social welfare payments or even outright stealing of profits by well-placed government officials. To give two examples: to examine a coal company, I interviewed the head of a state firm that is in charge of designing mine construction. Apparently, the only reason the company was listed in Hong Kong was to “to siphon profits to the parent” in Beijing. The comment alone was enough to raise red flags about the liscto’s financial statements.

In another case, the investors were concerned that a for-profit school owned by the listco’s chairman was funnelling profits from the listco to the chairman’s personal company. We visited the school (and the town) and were told by several locals that the school was probably losing money. Instead of generating profits, the school was likely launched to curry favour with local government officials, possibly in exchange for tax breaks. So what appeared to be a negative (misuse of corporate funds for personal gain) was most likely a positive (tax breaks) – albeit in an unorthodox and possibly illegal manner.

Investors using a western framework to analyse Chinese companies often miss the bigger context. They need to realize that, in China, politics and economics are intertwined. Failing to understand this relationship is like missing the forest for the trees.

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